No. 77-832

In the Supreme Court of the United States

OCTOBER TERM, 1977

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, PETITIONER

v.

FIRST LINCOLNWOOD CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The opinion of the court of appeals *en banc* (Pet. App. 1a-12a) is reported at 560 F.2d 258. The opinion of a panel of the court of appeals (Pet. App. 15a-32a) is reported at 546 F.2d 718. The order of the Board of Governors of the Federal Reserve System (Pet. App. 24a-27a) is reported at 62 Fed. Res. Bull. 153.

JURISDICTION

The judgment of the court of appeals on rehearing *en banc* (Pet. App. 13a-14a) was entered on July 13, 1977. On October 4, 1977, Mr. Justice Stevens extended the time within which to file a petition for a writ of certiorari to November 10, 1977, and on November 1, 1977, he further extended the time to and including December 10, 1977. The petition was filed on December 9, 1977, and granted on February 21, 1978. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the Federal Reserve Board must approve an application to form a new bank holding company, even though the financial structure of the company and the bank involved would be unsound, unless formation of the company would cause or worsen unsound financial conditions in the bank.

STATUTE INVOLVED

Section 3 of the Bank Holding Company Act of 1956, 70 Stat. 134-135, as amended, 12 U.S.C. 1842, provides in pertinent part:

> (a) It shall be unlawful, except with the prior approval of the Board, (1) for any action to be taken that causes any company to become a bank holding company; * * *.
>
> * * * * *

> (c) The Board shall not approve—
>
> (1) any acquisition or merger or consolidation under this section which would result in a monopoly, or which would be in furtherance of any combination or conspiracy to monopolize or to attempt to monopolize the business of banking in any part of the United States, or
>
> (2) any other proposed acquisition or merger or consolidation under this section whose effect in any section of the country may be substantially to lessen competition, or to tend to create a monopoly, or which in any other manner would be in restraint of trade, unless it finds that the anticompetitive effects of the proposed transaction are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served.
>
> In every case, the Board shall take into consideration the financial and managerial resources and future prospects of the company or companies and the banks concerned, and the convenience and needs of the community to be served.

STATEMENT

1. The First National Bank of Lincolnwood (the Bank) is owned and controlled by four persons. They organized respondent, the First Lincolnwood Corporation, to serve as a bank holding company.[1] The

[1] A "bank holding company" is defined in Section 2(a) of the Bank Holding Company Act, as amended, 12 U.S.C. 1841

owners sought to transfer to respondent both their shares in the Bank and their $3.7 million debt to the Central National Bank of Chicago, a debt secured by those shares and incurred at the time the owners acquired the Bank.[2] In return, the owners would receive the shares of respondent. Respondent would acquire more than 80 percent of the Bank's common stock and assume the personal debt of the stockholders. In addition, respondent planned to issue $1.5 million in 17 year capital notes, using the proceeds to purchase new shares to be issued by the Bank. The purchase would provide the Bank with additional capital. Over the coming years, the dividends on the shares held by respondent would be used to retire the acquisition debt (Pet. App. 17a-19a).

Respondent's acquisition of the Bank would involve a formal restructuring of ownership (Pet. App. 26a). The immediate practical effect of these transactions would be to relieve the Bank's shareholders of primary obligation for the $3.7 million debt and to

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(a), as "any company which has control over any bank [or] over any company that is or becomes a bank holding company * * *." "Any company has control over a bank * * * if [*inter alia*] * * * the company * * * owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the bank * * *."

[2] This debt was incurred when the current owners of the Bank bought out, or reduced to minority stockholder status, the Bank's former owners and managers after three of those principal officials were indicted for employing the Bank in a stock manipulation scheme that left the Bank in serious financial difficulties (Pet. App. 28a n. 1).

permit tax savings through the filing of a consolidated tax return.[3]

2. Respondent could not acquire the Bank without first obtaining approval of the Federal Reserve Board (the Board), which supervises bank holding companies under the Bank Holding Company Act (the Act). See generally *Whitney National Bank* v. *Bank of New Orleans & Trust Co.*, 379 U.S. 411. A company seeking to acquire a bank must file an application with the appropriate Federal Reserve Bank,[4] which initially evaluates the proposal and submits a report of relevant facts and recommendations to the Board for decision.[5]

Respondent submitted its application to the Federal Reserve Bank of Chicago. The Chicago Reserve Bank concluded that the Bank's capital position was weak[6]

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[3] If the Bank and respondent were to file a consolidated tax return, the interest on the debt to be assumed by respondent ($260,000 in the first year) could be deducted from the income earned by the Bank in calculating the taxable income of the consolidated entity. The tax savings, which would be approximately $130,000 the first year, could then be transferred to respondent, as a tax-free intercorporate dividend, and used by respondent to retire the acquisition debt. 26 U.S.C. 1501; 26 C.F.R. 1.502-14(a)(1). See Pet. App. 18a-19a.

[4] 12 C.F.R. 225.3(a) and 262.3(b).

[5] 12 C.F.R. 262.3(c).

[6] The Board employs several methods to evaluate the adequacy of capital, the difference between assets and liabilities that represents the margin of protection for the banks' depositors. One standard method is the invested asset ratio, which is the ratio of equity capital to liabilities, less cash on hand; another method is the capital/asset ratio, which is the

and that respondent might be unable adequately to service its debts without further weakening the Bank's capital and financial condition. But "[d]espite the probability that capital ratios may be below Board guidelines" the Chicago Reserve Bank recommended that the Board approve the application because the current management was capable, because respondent proposed to raise $1.5 million in equity capital for the Bank, and because of the tax advantages (A. 21).[7]

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ratio of total capital to total assets. See Heller, *Handbook of Federal Bank Holding Company Law* 129-132 (1976).

These two ratios indicated that the Bank's capital position was weak. The invested capital ratio was 5.3 percent on September 30, 1975 (A. 52). The Board has suggested that the ratio should be at least 9 percent, and the mean ratio for banks similarly situated to the Bank here is 10 percent. Hearings on Problem Banks before the Senate Committee on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess. 137 (1976). The Bank's capital/asset ratio in 1975 was 5.2 percent (A. 52). The Board does not generally consider a bank to be soundly capitalized unless the ratio is 8 percent or more.

The Board's staff estimated that the Bank and respondent must acquire between $2.5 and $3.1 million in additional capital to put the Bank on a sound footing (A. 52). But if the Bank must distribute revenues to respondent at a rate sufficient to enable respondent to meet its debt obligations, the Bank's capital/asset ratio would remain below 6 percent during the 12 years proposed by respondent as the debt retirement period, even taking into account the tax savings made possible by the filing of a consolidated income tax return (A. 54).

[7] The recommendation stated (A. 21):

Bank has a sound asset structure and satisfactory management; however, its capital sufficiency is less than adequate. Although the proposed $1.5 million equity infusion by [respondent] would initially raise capital to a marginally adequate level, [respondent's] high degree of leverage (88 percent of first year assets) and associated debt retirement program, may strain future capital adequacy in view of Bank's recently dramatic deposit growth.

The Comptroller of the Currency, who also submitted a recommendation to the Board,[8] concluded that approval of the transfer "should be denied until [the Bank's] capital, as distinguished from [the capital of] the holding company, is strengthened" (A. 39). The Comptroller thought that the Bank's earnings might not be adequate to service the "substantial long-term debt" incurred by the enterprise (*ibid.*). The Comptroller also was concerned that the formation of the holding company was designed principally to relieve the Bank's present owners of their personal and primary liability to discharge the $3.7 million acquisition debt (*ibid.*).

After receiving these adverse comments, the principal shareholders modified their original proposal by eliminating the plan to have respondent issue $1.5 million in capital notes. The new plan proposed that the Bank would make a combination capital note and stock issue.[9] This modification was intended to im-

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[8] The Comptroller advises the Board with respect to applications for the formation of bank holding companies, but the Board is not required to follow the Comptroller's recommendation (12 U.S.C. 1842(b)). See *Whitney National Bank*, *supra*, 379 U.S. at 419-421.

[9] The details of the proposal were (A. 40-43):

(1) The Bank would sell to its present customers $1 million of its capital notes, each with a maturity not to exceed 15 years, and (2) the Bank would sell $1.1 million of com-

prove the Bank's current capital position by $2.1 million, rather than the $1.5 million increase contemplated in the original proposal, but the Bank's debt would be increased by $1 million, and its equity capital would be increased by only $1.1 million (A. 40-41).

The Chicago Reserve Bank again supported the application after reviewing the new plan. It observed, however, that the diminution of the increase in equity capital was "a slightly unfavorable aspect of [respondent's] revised plans," and that the immediate capital position of the Bank "would remain less than adequate but substantially improved" (A. 36).

The change in respondent's plan was received more favorably by the Comptroller, who, on September 27, 1975, changed his recommendation to approval of the application (A. 51).

Members of the Board's staff then prepared and submitted to the Board analyses of and recommendations on the proposal.[10] The staff recommended denial of the application, concluding that "the strain on the Bank's earnings to service [the] $3.7 million debt, in itself, is sufficient to warrant denial of the application" (A. 54). The staff expressed concern that the principal shareholders might be compelled to incur further debt to purchase the additional stock called

mon stock, of which 15,756 shares would be purchased by the principal shareholders and exchanged for respondent's stock, in order to maintain respondent's 80 percent ownership of the Bank.

[10] See 12 C.F.R. 262.3(c).

for under the amended proposal. It observed that the shareholders "have limited amounts of liquid assets," and that, therefore, despite the owners' "stated intention not to use borrowed funds * * * the Board staff believes it likely that debt may be used to make the capital contributions" (A. 54). The staff therefore recommended against approval of the proposed acquisition, explaining that (*ibid.*):

> Under each amortization assumption, Bank's capital is strained by the debt incurred. In view of these [capital/asset] ratios, and the uncertainty as to the source of funds for the proposed injections, Board staff concludes that the proposal reflects limited financial flexibility and does not warrant approval. While present Bank management is regarded as capable, it would appear desirable that Bank's overall financing arrangements for the proposed capital injections into Bank should be made more definite.

On January 9, 1976, the Board voted to deny respondent's application on financial grounds (Pet. App. 24a-27a). In accepting the recommendation of its staff, the Board stated that it "had indicated on previous occasions that a bank holding company should be a source of financial and managerial strength to its subsidiary bank(s)" (*id.* at 25a) and that respondent would be unable to provide this strength. "In the Board's view, the projected earnings of [respondent] over the debt retirement period appear to be somewhat optimistic in view of Bank's previous earnings record and, even if actually realized, would not provide [respondent] with the financial

flexibility necessary to meet its annual debt service requirements while maintaining adequate capital at Bank" (*ibid.*).

The Board also was "concerned that the financial requirements imposed upon [respondent] as a result of the acquisition debt, and uncertainty as to the source of funds for Bank's proposed capital injections, could prevent [respondent] from resolving any unforeseen problems that may arise at Bank" (Pet. App. 25a-26a). The Board concluded (*id.* at 26a):

> On the basis of the above banking factors, and other facts of record, the Board is of the view that it would not be in the public interest to approve the formation of a bank holding company with an initial debt structure that could result in the weakening of Bank's overall financial condition. Accordingly, the Board concludes that the considerations relating to the banking factors weigh against approval of the application.

3. A divided panel of the court of appeals affirmed, stating that "we have no difficulty in finding that there is substantial evidence to support the denial of [respondent's] application" (Pet. App. 19a).[11]

On rehearing *en banc* the court of appeals set aside the Board's order (Pet. App. 1a-12a). The court reasoned that, although "the Board is empowered to

[11] The panel also rejected two other arguments respondent had made (see Pet. App. 20a-23a). Respondent did not renew these arguments before the *en banc* court (see *id.* at 12a n. 5), and they are not presented for decision in this Court.

deny approval of a bank acquisition upon finding it not to be in the public interest for reasons other than an anticompetitive tendency * * *, the condition or tendency deemed not to be in the public interest must be caused or enhanced by the proposed transaction" (*id.* at 7a). The court ruled that the Board could not "consider questions of bank soundness and public need apart from how these would be altered by formation * * * of a bank holding company" (*id.* at 9a).

The court concluded that respondent's acquisition of the Bank would not itself adversely affect the Bank's financial condition (Pet. App. 4a-5a). The court regarded respondent's assumption of a substantial indebtedness, even in light of the Bank's low capitalization, to be irrelevant, because the indebtedness would simply be shifted from the Bank's current owners to respondent. The acquisition, the court concluded, would not impair "the soundness of operation of the bank" (*id.* at 10a). To the contrary, the court expressed the view that "[t]he only identified effects of the acquisition [*i.e.*, the prospect of tax savings,[12] and the proposed infusion of capital] militate in favor of the acquisition" (*id.* at 11a-12a). The court of appeals therefore remanded the matter to the Board for its approval of respondent's application unless "relevant circumstances * * * have changed" (*id.* at 12a).

[12] See note 3, *supra*.

SUMMARY OF ARGUMENT

The bank holding company structure has definite advantages to the bank's stockholders over direct ownership. The stockholders can consolidate their control and enjoy tax advantages; the bank can avoid restrictive state branch banking laws and engage in some nonbanking businesses. But those advantages also make the holding company an attractive vehicle for speculation in bank stocks. The tax advantages encourage excessive reliance on debt financing, and the holding company device may lead to a drain on the bank's resources.

Congress has directed the Board to control the formation of bank holding companies. The Board attempts to evaluate the long term potential for harm arising from the creation of the holding company and to discourage speculation in bank stock. Holding companies often are beneficial, but, in order to protect against the risks that holding companies also create, the Board requires the holding company and the subsidiary bank to be soundly capitalized.

The plain language of the Bank Holding Company Act (12 U.S.C. 1842(c)) and its legislative history strongly support the Board's practices. The Act requires the Board "[i]n every case [to consider] the financial and managerial resources and future prospects" of the holding company and the bank concerned in determining whether to approve the creation of a bank holding company. The legislative history of this provision indicates that the Board is to

consider applications to form bank holding companies under the standards that have traditionally been applied by bank supervisory authorities. Those standards typically involve close scrutiny of the adequacy of the capitalization of the supervised banking entity.

The precursor of the provision at issue here explicitly required bank holding companies to maintain prescribed financial reserves as a condition of exercising ownership controls over a subsidiary bank or banks. This express condition was not included in the Bank Holding Company Act only because Congress concluded that it was unnecessary, in light of the power given the Board to assure that holding companies had adequate resources.

There is therefore ample reason to confirm the Board's consistent position that it will not approve the formation of a bank holding company when, because of undercapitalization or any other deficiency, the enterprise would not possess the financial and managerial attributes of a sound institution.

ARGUMENT

THE FEDERAL RESERVE BOARD NEED NOT ALLOW THE CREATION OF FINANCIALLY UNSOUND BANK HOLDING COMPANY SYSTEMS

The issue in this case is whether the Federal Reserve Board may disapprove the formation of financially unsound bank holding companies. The court of appeals here held that the Board must approve the formation of such a company so long as the bank's unhealthy financial condition would not be made *worse* by the formation of the holding company and the

other statutory factors (*e.g.*, competitive effects) are not adverse. We submit that the Board's regulatory authority under the Bank Holding Company Act permits it to disapprove the formation of financially unsound holding companies.

It is undisputed that both respondent and the bank to be acquired in this case were undercapitalized and thus in an unhealthy financial condition. The court acknowledged the presence of the Bank's "low capitalization ratio and the debt of its shareholders" (Pet. App. 11a), the very considerations that led the Board to deny the application. The record in this case amply justifies the Board's concern about the financial strength of the proposed holding company and the Bank. The Chicago Reserve Bank, the Comptroller of the Currency, the Board's staff and the Board itself expressed concern about the weakness of the Bank's capital position, the inadequate capital and excessive debt of the holding company, and the prospect of substantial, ever increasing debt being incurred by respondent's shareholders. See pages 5-10, *supra*. The total debt of the respondent—$3.7 million in existing debt and at least $1.1 million in new obligations represented by capital notes (see pages 7-8, *supra*)—together with the Bank's low capital/asset and invested asset ratios caused the Board's staff to conclude that "Bank's capital is strained by the debt incurred" and to recommend approval of the transaction be withheld on this ground alone (A. 54). The staff also was apprehensive that the Bank's owners would borrow still more money to pay for the addi-

tional stock called for in the amended application. In that event, the financial resources available to the enterprise would be further encumbered, and its strength correspondingly reduced. Based primarily on these factors, the Board concluded that the application should be denied.

The court of appeals did not dispute the Board's conclusion regarding the unsound financial situation of the enterprise.[13] It held that this concern is irrelevant and that the Board is required by law to permit the Bank's owners to form a one bank holding company, because to do so would not make the situation any worse than it already is. We submit, to the contrary, that the Act does not require the Board to approve the formation of a bank holding company in circumstances like this.

A. Holding Companies Should Be Financially Sound

The primary motivation for the formation of respondent evidently is to permit the Bank's owners to reduce their taxes (see note 3, *supra*).[14] (Although

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[13] The panel of the court of appeals held that the Board's conclusions concerning the Bank's unsoundness and respondent's excessive debt are supported by substantial evidence (Pet. App. 19a). The *en banc* court did not overturn this finding.

[14] The principal advantage would be to the shareholders whose acquisition debt would be assumed by respondent. If there is no holding company, the Bank will distribute dividends to its shareholders. The shareholders then could use the dividends, after paying taxes on the dividend income, to pay off their acquisition debts. If the holding company is formed, the Bank would pay dividends to the holding company,

the owners proposed an increase in the capitalization of the Bank through the issuance of stock and long term notes, the Board's staff observed that this benefit to the Bank would be nullified over the debt retirement period by the strain on the Bank in servicing the holding company's heavy acquisition debt. But the tax advantages are not the only reason why the formation of a holding company would be attractive to the Bank's owners. A bank holding company may expand into banking-related activities with Board approval (12 U.S.C. 1843(c)(8)). The holding company may avoid the strictures of state laws that restrict branch banking [15] and may acquire funds without regard to the interest ceilings and reserve requirements that apply to banks. In principle,

which need not pay income tax on them. The tax advantages of this intercorporate dividends exclusion would accrue to the holding company, and thus to the individual shareholders.

The Bank also would receive some benefits. To the extent the holding company would have interest payments exceeding its profits, the surplus interest deductions could be offset against the Bank's earnings to reduce the Bank's taxes. The Bank thus would have additional sums that could either be used to reduce the debt or be retained. The latter course would increase the Bank's net worth and thus increase the value of the shares of the holding company. The former course would yield benefits only for the holding company. The individual shareholders of the holding company therefore would benefit no matter how the tax savings were allocated.

[15] 12 U.S.C. 36(c)(2); *Whitney National Bank* v. *Bank of New Orleans & Trust Co.*, 379 U.S. 411, 413.

the holding company device also could be used to concentrate control of ownership.[16]

The advantages to the shareholders of the creation of the holding company are thus substantial.[17] But the risks to the public from the abuse of the holding

[16] The owner of a bank could organize a holding company that would own 50.1 percent of the bank's stock. If the owner then sold the remaining 49.9 percent to the public, and also sold to the public 49 percent of the shares of the holding company, he still would have effective control of the bank. He would have only 26 percent of the equity investment in the bank; yet he would control the holding company, and the holding company would control the bank. (This does not happen in practice, however, because the holding company would lose the tax advantages that are a primary inducement for its existence.)

[17] The significance of these advantages is indicated by both the extensive use of bank holding companies and the Board's ability to obtain substantial commitments as conditions of approving the creation of such holding companies. Banking subsidiaries of holding companies held 66 percent of all commercial deposits in the United States as of December 31, 1976 (Hearings on Federal Bank Commission Act of 1977 before the Senate Committee on Banking, Housing and Urban Affairs, 95th Cong., 1st Sess. 66 (1977). The Board frequently approves a holding company's acquisition of a bank only on the condition that the company increase the bank's capital (see, *e.g.*, *Denver U.S. Bancorp. Inc.*, 56 Fed. Res. Bull. 291; *Michigan National Corp.* 58 Fed. Res. Bull. 804). Since 1970 such conditions have added almost $2 billion to the net capital of the nation's banks. See Hearings on Financial Institutions and the Nation's Economy (FINE)—Discussion Principles before the Subcommittee on Financial Institutions Supervision, Regulations and Insurance of the House Committee on Banking, Currency and Housing, 94th Cong., 1st and 2d Sess., Part 3, 2403 (1975-1976). (The concessions the Board requires in exchange for approval are judicially enforceable. 12 U.S.C. 1818(b) and (i).)

company device also may be substantial. The tax advantages to the shareholders make the holding company an attractive vehicle for speculation in bank stocks. A speculator can borrow money to purchase a bank, offering the newly-purchased shares of the bank's stock to secure repayment of the loan. Then, by forming a holding company, he can avoid taxes on the Bank's dividends while using the Bank's earnings to pay off his debt (as the shareholders propose to do here). The process allows tax-free, and practically risk-free, accumulation of wealth. The shares of the holding company increase in value as the acquisition debt is repaid. The owner then can sell the holding company shares, paying taxes on the lower capital gains rate. This not only substantially defers tax payments but also converts ordinary income into capital gain. The greater the acquisition debt, the greater the tax savings will be.

In principle, a person could acquire a bank using none of his own money. The entire acquisition could be financed by the bank's earnings and the federal treasury.[18] But the greater the acquisition debt, the greater the risk to the bank. The creation of the holding company and the transfer to it of the acquisition debt does not increase the bank's equity capital. The size of the debt may lead to unsound banking prac-

[18] The Board disfavors the creation of a bank holding company if the acquisition debt assumed by the holding company exceeds 75 percent of the cost of the bank shares. 12 C.F.R. 265.2(f) (22) (xi). This approach is of doubtful validity under the court of appeals' analysis.

tices (such as making high risk loans) in order to maximize the Bank's earnings to permit rapid retirement of the acquisition debt. The holding company device makes speculation in buying and selling banks more profitable than it would be if the acquisition debt remained in the hands of the individual stockholders, to be paid out of the taxable dividends received from the bank.[19]

The flexibility of the holding company in incurring additional debt offers a further opportunity for speculation. Because the unwary investor or depositor may assume that the bank's assets secure the obligations of the bank holding company, the failure of the holding company to meet its obligations could jeopardize the solvency of an otherwise healthy subsidiary bank.[20]

In sum, although holding companies serve legitimate purposes,[21] the opportunity to form holding

[19] The Board's policies on capital and debt restrain speculation in bank stocks because they notify bank purchasers that, in order to obtain the advantages of bank holding company status, they must demonstrate responsible and sound financial and managerial resources.

[20] This is precisely what happened to the Beverly Hills National Bank. The subsidiary bank itself was solvent and was satisfactorily liquid. But when the parent holding company failed to meet its obligations, there was a "run" on bank deposits. More than $20 million was withdrawn in a few days, and the bank was sold in order to avoid involvency. See *American Banker*, January 2, 1974, p. 1; *id.* at January 25, 1974, p. 1.

[21] In addition to creating the opportunity for ownership diversification discussed above, a financially strong holding

companies is not an unmixed blessing. There is a potential for abuse, which can work to the detriment of the subsidiary bank and its depositors. The Board of Governors therefore seeks to ensure that every holding company is soundly capitalized—and that its subsidiary bank is soundly capitalized. The legitimacy of the Board's concern does not depend, as the court of appeals thought, on whether the formation of a holding company causes the immediate deterioration of the bank's condition. The Board is of course concerned about immediate effects, but its broader policies are based on long-term effects and on possibilities in the run of cases.[22] The Board's policy not only

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company increases the stability of its subsidiary bank. See S. Rep. No. 1095, 84th Cong., 1st Sess. 15 (1955):

> Downstream financing [borrowing by subsidiary from parent] enables the bank holding company to draw on the equity capital of its shareholders and its own operating funds in order to strengthen the financial condition of any one or more of its subsidiaries. In the past, this has operated not only to the advantage of the bank holding company system itself, but also to the advantage of shareholders and depositors of the subsidiary bank so assisted and the public served by the subsidiary bank.

See also Hearings on S. 2577 (Control of Bank Holding Companies) before the Senate Committee on Banking and Currency, 84th Cong., 2d Sess. 53 (1956).

[22] The court of appeals analysis apparently would deny to the Board any authority to disapprove the formation of a holding company with demonstrably inept or corrupt management, if the same persons already managed the bank, because the creation of the holding company would not cause or enhance the undesirable management situation. It seems clear, however, that the Board should not be required to allow

serves to discourage prospective speculative bank acquisitions but also encourages those who control banks to strengthen those institutions so that they may obtain the benefits of holding company status.[23] The Board's approval thus becomes a tool for improving the health of financial institutions, not simply a means for preventing their immediate deterioration.

B. The Statute Authorizes The Board To Deny Holding Company Status To Unsound Ventures

1. Congress has given the Board extensive powers to control the formation and activities of bank holding companies. No bank holding company may be created without the Board's approval (12 U.S.C. 1842 (a)), and the statute prohibits approval if the creation of the holding company would have an anticompetitive effect (12 U.S.C. 1842(c)). In all other circumstances, Congress has vested the Board with substantial discretion to approve or deny an application because of financial considerations. "It was upon the basis of these factors that the Federal Reserve Board is to measure whether each application should be ap-

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corrupt or inept managers to assume control of a bank holding company. The same reasoning applies in undercapitalization cases.

[23] The recurring national concern regarding "problem banks" is reflected in the January 31, 1977, study of the Comptroller General of the United States, *Highlights of a Study of Federal Supervision of State and National Banks*. The Comptroller noted the congressional concern "over large bank failures in recent years" (p. 1) and recommended improvements in bank regulation. See also note 20, *supra*.

proved or denied in the public interest." S. Rep. No. 1095, 84th Cong., 1st Sess. 10 (1955).

The statute provides that, in determining whether to approve the creation of a bank holding company (*ibid.;* emphasis added):

> In every case the Board shall take into consideration the *financial and managerial resources and future prospects* of the company or companies and the banks concerned, and the convenience and needs of the community to be served.

Although the court of appeals correctly concluded that this language authorizes the Board "to deny approval of a bank acquisition upon finding it not to be in the public interest for reasons other than an anticompetitive tendency" (Pet. App. 7a; see also S. Rep. No. 1095, 84th Cong., 1st Sess. 10 (1955)), it erred in limiting the Board's consideration of the public interest to the immediate effects of the transfer of bank ownership to the holding company. Nothing in the language or purpose of the statute suggests such a limitation—to the contrary, Congress instructed the Board to consider not only the current financial and managerial resources of both bank and holding company but also their future prospects. Congress thus provided that the Board should consider not only immediate effects but also long range risks.

The court of appeals effectively read the statute as dealing only with the problems caused by holding companies that control more than one bank. When only a single bank is involved, the holding company acquisition would not pose competitive problems, and the

transfer from individual to corporate ownership rarely would cause immediate difficulties for the bank. But the statute is not limited to multiple bank holding companies. In extending the Act to one bank holding companies in 1970 (84 Stat. 1760), and requiring those seeking such status to go through the costly and time consuming application process, Congress could scarcely have intended that the Board would have no discretion to consider the bearing of the "financial and managerial resources of the company * * * and the bank[] concerned [on the] * * * needs of the community to be served." Not only the plain language of the statute but also its specific extension to single bank holding companies demonstrates the court of appeals' error.

2. As this Court explained in *Whitney National Bank* v. *Bank of New Orleans & Trust Co.*, 379 U.S. 411, 420, the Bank Holding Company Act "was designed to permit an agency, expert in banking matters, to explore and pass on the ramifications of a proposed bank holding company arrangement." This exploration necessarily involves consideration of the financial health not only of the proposed holding company, but also of the subsidiary bank.[24] The Court

[24] The court of appeals is accordingly incorrect in suggesting that questions of "bank soundness" are "reserved to the Comptroller of the Currency" (Pet. App. 9a). The Board and the Comptroller each must consider the proposal. The Comptroller then advises the Board (12 U.S.C. 1842(b)), but the Board is not required to follow the Comptroller's recommendation. *Whitney National Bank* v. *Bank of New Orleans & Trust Co.*, *supra,* 379 U.S. at 417-420. Cf. 12 U.S.C. 78, 248(a), 301, 371b,

therefore concluded in *Whitney* that the Board may disapprove the formation of any holding company system the organization of which would be "beyond the limits consistent with the public interest" (379 U.S. at 421).

The Board's responsibilities include the continuing supervision and regulation of bank holding companies to assure their safe operation according to sound banking practices. 12 U.S.C. 1818(b)(1) *et seq.;* S. Rep. No. 1095, 84th Cong., 1st Sess. 14-15 (1955). The authority to prevent the formation of financially unsound holding companies is a natural and effective part of this supervisory power. The Board's power logically extends to preventing the formation of bank holding companies that are likely to be substandard, as well as to assuring that existing companies comply with established standards. Moreover, it is entirely consistent with the statutory emphasis on the importance of assuring the strength of bank holding companies and their subsidiary banks for the Board to condition the grant of holding company status on the improvement of marginally adequate banks. Even when these deficiencies are not so serious as to require the use of corrective sanctions,[25] the financial

377, 461, 601 (relating to regulation and supervision of national banks by the Board independently of the Comptroller of the Currency).

[25] The Board may issue cease and desist orders to halt unsound practices by bank holding companies. 12 U.S.C. 1818(b). Deficient capitalization would be a sufficient reason to issue such an order. It would be odd if the Board were required to approve the formation of a bank holding company with

health of the banking system is improved when the owners of such institutions are motivated to improve them in order to obtain the benefits of holding company status.

3. The legislative history amply confirms the Board's authority to consider the financial soundness of both the proposed holding company and the subsidiary bank in determining whether to approve the formation of a bank holding company.

The precursor of Section 3(c) of the Bank Holding Company Act was Section 19 of the Banking Act of 1933, 48 Stat. 186. Section 19 was designed to correct "evils which reached a peak of danger in 1929," evils that were characterized by the inflation of bank credit and bank insolvencies. See S. Rep. No. 584, 72d Cong., 1st Sess., Part 1, 2-5 (1932). Because a number of bank holding companies had collapsed in that period, Congress undertook to assure their "financial responsibility" (*Anderson* v. *Abbott*, 321 U.S. 349, 364). Section 19 required a bank holding company to obtain a permit from the Board as a prerequisite to voting a subsidiary bank's shares. The Board was required to consider the financial condition of the bank holding company before granting any permit. And if a holding company obtained a voting permit, it became subject to examination by the Board and was required, *inter alia*, to maintain a

inadequate capital but could then immediately order it to provide adequate capital (which it might not be able to do). Surely it is preferable to prevent the formation of unsound enterprises than to attempt to cure unsoundness later.

prescribed reserve of readily marketable assets in order to provide for the replacement of capital and to cover losses in its subsidiary bank or banks. Thus Congress explicitly provided that a bank holding company should serve as a source of financial strength to its subsidiary bank.

After Congress found that bank holding companies were avoiding compliance with the regulatory standards of Section 19 simply by declining to vote the shares of subsidiary national banks,[26] it enacted the Bank Holding Company Act of 1956, 70 Stat. 133. Under Section 3(c) of the 1956 Act the Board was required to consider an application to create a bank holding company on the basis of five enumerated factors: (1) the financial history and condition of the company and banks involved, (2) their prospects, (3) the character of their management, (4) the convenience, needs, and welfare of the communities concerned and (5) the competitive effect of the proposed acquisition.

The present standards in 12 U.S.C. 1842(c) result from the 1966 amendments to the Bank Holding Company Act; they are the same as the 1956 standards in every material way.[27] The 1966 amendments simply repealed the voting permit arrangement (80 Stat. 236) because it "serves no substantial purpose"

[26] See H.R. Rep. No. 609, 84th Cong., 1st Sess. 4-5 (1955).

[27] The 1970 amendments extended the Act's coverage to one bank holding companies but did not change the list of factors that the Board must consider in making decisions. 84 Stat. 1763.

in view of the authority granted to the Board by Section 3(c) of the Bank Holding Company Act to consider a holding company's financial resources. S. Rep. No. 1179, 89th Cong., 2d Sess. 12 (1966). In other words, Congress repealed the provisions of the Banking Act that required bank holding companies to have prescribed capital only because, in Congress' view, the Board had the authority to enforce a financial resource standard under the Bank Holding Company Act.

The legislative history of the 1956 Act demonstrates that Congress intended the Board to function like any other bank supervisory authority in determining the financial soundness of a banking institution; Congress gave the Board the additional task of considering anticompetitive effects attributable to the creation of a holding company, but that did not make the Board's role as a banking supervisor the less important (S. Rep. No. 1095, 84th Cong., 1st Sess. 10 (1955)). The standards of Section 3(c) were intended to reflect "in general the considerations now specified in the law as the basis for administrative action in connection with the admission of State banks to membership in the Federal Reserve System and the granting of deposit-insurance coverage." H.R. Rep. No. 609, 84th Cong., 1st Sess. 15 (1955).

Careful scrutiny of the financial condition of the banking entity has been a fundamental part of agency review of applications for Federal Reserve System membership and of federal deposit insurance coverage. The agencies administering these programs

clearly have the authority to deny the application solely because of the financial weakness of the applicant.

For example, a state bank seeking admission to the Federal Reserve System must possess "capital stock and surplus which, in the judgment of the Board of Governors of the Federal Reserve System, are adequate in relation to the character and condition of its assets and to its existing and prospective liabilities and other corporate responsibilities * * *" (12 U.S.C. 329).[28] In acting on applications for membership in the Federal Reserve System, the Board must "consider the financial condition of the applying bank, the general character of its management and whether or not the corporate powers exercised are consistent with the purposes of this Act" (12 U.S.C. 322).[29]

[28] This language dates from the 1952 amendments to the Federal Reserve Act. 66 Stat. 633. Before 1952 Section 9 of the Federal Reserve Act of 1913 had required banks applying for membership to comply with the "reserve and capital requirements" established by the by-laws of the Board and to possess sufficient paid-up and unimpaired capital to entitle the state-chartered bank to become a national bank. 38 Stat. 251. See S. Rep. No. 1623, 82d Cong., 2d Sess. 1 (1952).

[29] Congress decided in 1913 that in acting on membership applications the "greatest care should be exercised with respect to the capital and reserves of applying banks." H.R. Rep. No. 69, 63d Cong., 1st Sess. 42 (1913). The Senate Report on the membership provisions indicates that state banks could become members only when "the capital stock, sound condition, subscription, and compliance with the rules of the system" justify admission. S. Rep. No. 133, 63d Cong., 1st Sess., Part 2, 11 (1913).

Similarly, the factors to be considered in determining whether a bank may be insured under the Federal Deposit Insurance Act, 64 Stat. 873, as amended (12 U.S.C. 1811 *et seq.*) include (12 U.S.C. 1816):

> [T]he financial history and condition of the bank, the adequacy of its capital structure, its future earnings prospects, the general character of its management, the convenience and needs of the community to be served by the bank, and whether or not its corporate powers are consistent with the purposes of this chapter.

These factors are derived from Section 101(g) of the Banking Act of 1935, 49 Stat. 688, which identifies them as "those which are considered by the Comptroller of the Currency in authorizing national banks to commence business." S. Rep. No. 1007, 74th Cong., 1st Sess. 3 (1935). The Comptroller's investigation of new bank applications traditionally has included consideration of such matters as the financial soundness of the proposed bank and the "reasonable prospects for success of the new bank if efficiently managed." See Instructions of the Comptroller of the Currency Relative to the Organization and Powers of National Banks, 1920, reprinted at 74 Banking L.J. 925 (1957).

4. We submit, then, that the language of the statute, the process of its evolution, and the accompanying legislative reports all demonstrate that Congress has authorized the Board of Governors to apply the traditional banking regulation standards in deciding whether to approve the formation of a new bank hold-

ing company. If, in the Board's view, the enterprise would be too thinly capitalized, then the Board is entitled to withhold its approval. It need not find that the creation of the holding company will make things immediately worse than they are because, when conditions are shaky to begin with, the very formation of the holding company creates risks that do not exist when the bank operates by itself.

If there is any doubt in this, the doubt should be resolved by reference to the Board's consistent practice—a practice clearly announced and left undisturbed by Congress. "[T]he Board has played a vital role in the development of the national banking laws, a role which makes its views of particular benefit to the courts." *Whitney National Bank* v. *Bank of New Orleans & Trust Co., supra*, 379 U.S. at 421. The Board has authority to issue all necessary orders and regulations (12 U.S.C. 1844(b)), and this Court has indicated that these orders and regulations should be sustained unless they are plainly wrong. *Mourning* v. *Family Publications Service, Inc.*, 411 U.S. 356, 369-374.

The Board has regularly declined to approve the formation of bank holding companies when, because of undercapitalization or any other deficiency, the enterprise would not possess the financial and managerial attributes of a sound banking institution.[30] See, *e.g.*, *Clayton Bancshares Corp.*, 50 Fed. Res. Bull. 1261; *Mid-Continent Bancorp.*, 52 Fed. Res. Bull.

[30] See Heller, *supra*, at 129-138.

198; *Midwest Bancorp.*, 56 Fed. Res. Bull. 948. After Congress extended the Board's regulatory authority in 1970 to supervision of one-bank holding companies, the Board applied this same standard to applications to form one-bank holding companies. See, *e.g.*, *Bankshares of Hawley, Inc.*, 62 Fed. Res. Bull. 610; *Citizens Bancorp.*, 61 Fed. Res. Bull. 806; *Downs Bancshares, Inc.*, 61 Fed. Res. Bull. 673. The Board's interpretation that bank holding companies should be adequately financed and provide strength to their subsidiary banks was well known and consistently applied when Congress extended the Board's authority in 1970. It was referred to by Congress in 1955 (see S. Rep. No. 1095, 84th Cong., 1st Sess. 15 (1955)) and has been discussed by Congress, with apparent approval, quite recently (see S. Rep. No. 95-323, 95th Cong., 1st Sess. 11 (1977)). In these circumstances the presumption is strong that Congress has ratified the Board's view of its authority. See, *e.g.*, *Lorillard* v. *Pons*, No. 76-1346, decided February 22, 1978; *Saxbe* v. *Bustos*, 419 U.S. 65, 74. The Board's "reading and application of the statute involved in this case * * * are long established, have remained undisturbed by Congress, and fall well within that category of situations in which the courts should defer to the agency's understanding of the statute which it administers." *National Labor Relations Board* v. *Enterprise Association*, 429 U.S. 507, 528.[31]

[31] See also, *e.g.*, *Red Lion Broadcasting Co.* v. *Federal Communications Commission*, 395 U.S. 367, 381; *Udall* v. *Tallman*, 380 U.S. 1, 16. The courts of appeals have regularly given

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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substantial weight to the Board's interpretation of the statutes it administers. See, *e.g. Association of Bank Travel Agents* v. *Board of Governors*, 568 F.2d 549, 552 (C.A. 7); *Alabama Association of Insurance Agents* v. *Board of Governors*, 533 F.2d 224, 239 (C.A. 5), certiorari denied, February 28, 1978 (No. 77-668). See also *Board of Governors* v. *Agnew*, 329 U.S. 441, 449-450 (Rutledge, J., concurring).

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